

IT 00-0068-GIL 09/13/2000 SUBTRACTION MODIFICATIONS – INTEREST ON U.S.  
GOVERNMENT OBLIGATIONS

General Information Letter: The subtraction modification allowed for interest on U.S. government obligations is net of bond premium amortization, but is not reduced for expenses allocable to such income.

September 13, 2000

Dear:

This is in response to your letter dated August 30, 2000. Given the nature of your inquiry and the information you provide, I am responding with a General Information Letter. This is not to be taken as a statement of Department policy or as a binding ruling by the Department. As general information gathered in response to your particular questions, however, I hope that it is helpful to you. See 86 Ill. Adm. Code 1200.120(b) and (c), which can be obtained at the following website:

<http://www.revenue.state.il.us/legalinformation/regs/part1200>.

In your letter you have stated the following:

I am writing you to request a ruling on an issue that affects approximately 700 of our IL-1041 irrevocable trusts. The issue involves the correct amount of U.S. Treasury and federal agency interest to take as a subtraction modification on the IL-1041 return. I see 3 different scenarios that are possible. The first would be to take the gross amount (net of any bond premium amortization) that was included in the federal taxable income. The second would be to take the net (after allocating any expenses) amount that was included in federal taxable income. The third would be to do some kind of reallocation of expenses with the U.S. government interest now being tax exempt.

I have included an example and the result each of the different scenarios would yield using the facts in the example.

Example:

Federal exempt and Illinois taxable municipal interest	10,000
U.S. Treasury interest	20,000
Total	30,000

Indirect expenses subject to allocation	3,000
---	-------

On the federal return the taxable income would be 18,000, all of which is made up of U.S. government interest. It is calculated as follows:

Tax exempt interest of 10,000 divided by total income of 30,000 times expenses subject to allocation of 3,000 equal 1,000 of expenses allocable to tax exempt income. Total indirect expenses of 3,000 less the 1,000 allocable to tax exempt leaves 2,000 allocable to taxable income. Taxable income is made up of 20,000 of U.S. Treasury interest less the 2,000 allocated against it for a total of 18,000.

If we took the first of the 3 scenarios listed above, which is the gross method, the subtraction would be the full 20,000. If the trust were a simple trust and everything were being distributed to the beneficiary, they would receive a subtraction of 20,000 to use on their personal return.

If we took the second scenario listed above, the subtraction would be 18,000, which was the net U.S. interest after expenses. Again if the trust were a simple trust, beneficiary would receive a subtraction of 18,000 to use on their personal return.

The third scenario is a bit more complicated. Since we are now looking at the return from an Illinois standpoint, we need to flip the fraction for allocation of expenses because the U.S. Treasury interest now becomes tax exempt for Illinois and the municipal interest is now taxable for Illinois. The subtraction would be 18,000 calculated as follows:

Illinois exempt U.S. Treasury interest of 20,000 over 30,000 of total interest times allocable expenses of 3,000 equals 2,000 of expenses allocated to the 20,000 of U.S. Treasury interest for a net subtraction modification of 18,000. It just so happens that this is the same result that the second scenario yields. However, if you add another component to the total income, such as taxable dividends, the results for scenarios 2 and 3 would be different. I just wanted to keep the example simple and show the theory behind how scenario 3 might work.

As I mentioned, we have over 700 IL-1041's that we process and a majority of them have U.S. Treasury interest of some kind. We want to take the proper subtraction modification for Illinois.

To summarize, should the Illinois subtraction modification for U.S. Treasury interest on an IL-1041 be based on the gross amount of U.S. Treasury interest included in federal taxable income, the net amount (after allocable expenses) of U.S. Treasury interest included in federal taxable income, some sort of reallocation based on what is taxable and tax exempt for Illinois or some method I haven't mentioned?

## **Response**

The subtraction modification for interest on obligations of the United States is derived from the protections afforded the "Borrowing" and "Supremacy" clauses of the United States Constitution. These protections are codified in statute at 31 USCA 3124(a). Illinois Income Tax Regulations state that income exempt from the income tax includes "Interest on U.S. Treasury bonds, notes, bills, certificates and savings bonds" as a consequence of the federal constitution and enabling statute (86 Ill. Admin Code §100.2470(b)(2)(A)).

Interest on such obligations is not exempt from the Internal Revenue Code of the United States. The interest is taxed in the same manner as any other income under the IRC. It is subject to a deduction for expenses incurred in its production (IRC §212), because taxable income of a trust is "computed in the same manner as in the case of an individual" (IRC §641(b)).

Interest on United States obligations is reduced in that manner on the federal return only because it is taxable income. As exempt income on the Illinois return, however, it cannot be similarly reduced because its full amount is protected by the Constitution from taxation by the states. The full gross

amount of interest on qualified United States obligations included in federal taxable income (reduced by bond premium amortization), therefore, is a subtraction modification under Section 203(c)(2)(K) of the Illinois Income Tax Act.

Please do not hesitate to call me at (217) 782-2844 if you have further questions. As stated above, this is a general information letter that does not constitute a statement of policy that applies, interprets or prescribes tax law. It is not binding on the Department as a definitive statement of law. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b).

Sincerely,

Kent R. Steinkamp  
Staff Attorney -- Income Tax